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Statement of position regarding mandatory rotation of audit firms of publicly held companies

American Institute of Certified Public Accountants. SEC Practice Section

Division for CPA Firms

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STATEMENT OF POSITION REGARDING MANDATORY ROTATION OF AUDIT FIRMS OF PUBLICLY HELD COMPANIES

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SEC PRACTICE SECTION
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STATEMENT OF POSITION REGARDING MANDATORY ROTATION OF AUDIT FIRMS OF PUBLICLY HELD COMPANIES

Periodically, some observers of the public accounting profession have suggested that the quality of audits could be improved if audit firm rotation were required after some specified period. This recommendation rests on the premise that establishing a long-term client relationship can impair the auditors' objectivity.

The American Institute of CPAs, with approximately 305,000 members, is continually pursuing initiatives to enhance the quality of audits. As a result, any suggestion to enhance audit quality and objectivity is seriously considered. However, after studying the question of audit firm rotation, the Institute has concluded that there is no credible evidence that such a requirement would improve the quality of audits. To the contrary, the Institute believes that mandatory audit firm rotation would not be in the public interest. For one thing, it would dramatically increase costs for firms, clients and the public. In addition, it would increase the likelihood of poor audits, by depriving auditors of a most valuable tool: experience with a client and the resulting comprehensive knowledge of its business and operations.

This paper explains why mandatory audit firm rotation is not in the public interest. After reviewing the perceived problems that audit firm rotation claims to address, it discusses the costs and drawbacks of rotation; describes the expanding role of the auditor and the importance of audit independence; and demonstrates that there are already adequate safeguards—including a number of recently adopted measures—to maintain and improve the quality of audited financial information.

In brief, mandatory audit firm rotation is not necessary or appropriate because:

- Audits are strengthened by institutional continuity. It is a significant benefit to be well acquainted with a client's business, operations and controls. Experience shows that allegations of audit failure occur much more frequently when a firm is in its first couple of years as a company's auditors.
- Audit firm rotation is disruptive, time consuming and would increase overall audit costs.
- Key individuals involved in the audit process—audit firm personnel, client management and audit committee members—all change in the normal course of events anyway.
- Audit committees are in the best position to evaluate the desirability of changing auditors.
- Growing public expectations, regulatory changes and recent professional initiatives have all served to improve the auditing and financial reporting processes as well as to create an environment for ongoing improvement without the undesirable consequences of mandatory rotation.

MANDATORY ROTATION OF AUDIT FIRMS

Those who recommend mandatory rotation of audit firms believe that the auditors' focus is on maintaining a long-term economic relationship with a particular client and that this may compromise the auditors' objectivity and affect the way in which he or she discharges professional responsibilities. These critics believe that retaining the engagement becomes the auditors' priority. The concerns they have raised are:

1. Auditors tend to grow too close to the client's management. They begin to identify with management's problems and lose the requisite skepticism. Under rotation, a new audit firm would bring a fresh viewpoint.
2. Auditors become stale, viewing the examination as a repeat of earlier engagements with the same client. This fosters a tendency to anticipate results rather than keeping alert to subtle but important changes in client circumstances.

3. Auditors are tempted to smooth over problem areas in order to retain the engagement over the long term. If this happens, pleasing client management becomes the auditors' priority, rather than following professional standards. If the tenure of the audit firm were limited, auditors would have greater incentive to resist management pressure.

Litigation against accounting firms frequently alleges that the auditors compromised their objectivity to maintain the client relationship. While the majority of cases brought against auditors are dismissed or reach a favorable conclusion with respect to the auditors' performance, the mere frequency with which auditors are alleged to have "gone along with" client management makes an audit firm rotation requirement superficially appealing to some.

THE CASE AGAINST MANDATORY AUDIT FIRM ROTATION

While there is no empirical evidence to support the perceived benefit of mandatory audit firm rotation, there are a number of reasons why required rotation would be undesirable. The most significant are summarized below. Furthermore, it should be recognized that virtually every group that has studied this suggestion over the years, including the Public Oversight Board, Commission on Auditors' Responsibilities and National Commission on Fraudulent Financial Reporting, has concluded that the perceived benefits of rotating audit firms are clearly outweighed by the associated costs.

AUDITS IMPROVE WITH CONTINUITY

First and foremost, an audit firm rotation requirement intended to improve the objectivity of auditors and therefore the quality of audits is likely to have exactly the opposite effect. Problem audits occur much more frequently when the auditor lacks a solid base of experience with the client's business, operations and systems. Indications of the relationship between alleged audit failures and the lack of audit experience with the client come from a number of sources:

- The Quality Control Inquiry Committee of the SEC Practice Section—part of the AICPA's self-regulatory program that reviews litigation and other indications of audit deficiencies involving member firms to determine if quality control improvements are warranted—has analyzed 406 cases of alleged audit failure that were considered between 1979 and 1991. This analysis showed that allegations of audit failure occur *almost three times as often* when the audit firm is performing its first or second audit of the company.
- In its 1987 report, the National Commission on Fraudulent Financial Reporting stated that "the Commission's review of fraud-related cases revealed that a significant number involved companies that had recently changed their independent public accountants. . . ." As a consequence, the Commission recommended that the AICPA's SEC Practice Section should strengthen its peer review program by increasing the review of audit engagements involving public company clients new to a firm. That recommendation was promptly adopted by the SEC Practice Section.
- The independent Commission on Auditors' Responsibilities (1974–78), chaired by former SEC Chairman Manuel Cohen, stated, "(I)n the Commission's study of cases of substandard performance by auditors, several of the problem cases were first- or second-year audits. While not conclusive, this indicates the higher peril associated with new audit clients. Once an auditor becomes well acquainted with the operations of a client, audit risks are reduced. If a relationship between audit failures and new clients does exist, rotation would increase the problem and be detrimental to users."

Former SEC Chief Accountant John Burton summarizes the relationship between auditor changes and audit problems:

> "In the overwhelming majority of situations. . . the problem in these cases arose from too little involvement by the auditors in the activities of their clients, rather than too much. A significant proportion of the cases arose in initial audits where the main pattern was normally one of the client misleading the auditor rather than conspiring with him."[1]

[1]John C. Burton, "A Critical Look at Professionalism and Scope of Services," *Journal of Accountancy*, April 1980, page 50.

ROTATION WOULD INCREASE COSTS—DECREASE EFFICIENCY

Not only would the risk of audit failure increase, but mandatory auditor rotation would raise costs for firms, their audit clients and the public. Each time rotation occurred, management would face the prospect of a disruptive, time-consuming and expensive process of selecting new auditors and familiarizing them with the company's operations, procedures, systems and industry environment. Moreover, efficiencies developed by the prior auditing firm would be lost, again raising costs.

Then SEC Commissioner Phillip Lochner described this problem well in the January 1991 issue of *The Accountant*. Specifically, he noted that "As far as rotating auditors is concerned, it would substantially increase the cost of audits. Every X number of years, you would have to bring in and educate a whole new group of auditors. There are advantages to having an auditor who knows the business and the people."

ROTATION OCCURS IN THE NORMAL COURSE OF EVENTS ANYWAY

Increasing global competition is a dynamic component of today's society. In this environment, forced rotation of audit firms would add unnecessarily to the many significant changes that are already required of business to remain healthy and competitive. Such changes involve, among others, transitions in company management. As a matter of fact, as managers come and go or assume different responsibilities, auditor continuity provides a useful benchmark and experience to new executives.

To illustrate the current extent of management turnover in the United States, a review of the executive management of the largest 100 industrial concerns listed in the 1991 Fortune "500" shows the following management turnover:

- 7% of their chief executive officers have been employed by the company for less than five years; 47% hold their current position for under five years.
- 30% of their chief financial officers have been with the organization for less than five years; 68% hold the CFO position for less than five years.

A review of the executive management of the 50 largest bank holding companies at December 31, 1990 is presented below:

- 30% of their chief executive officers have been employed by the company for less than five years; 58% hold their current position for under five years.
- 56% of their chief financial officers have been with the organization for less than five years; 84% hold the CFO position for less than five years.

These statistics indicate that management evolution alone, even without mandatory audit firm rotation, tends to make the client management-auditor relationship a temporary one.

Furthermore, the audit firm personnel assigned to a particular client also periodically change enabling ongoing opportunities for a "fresh look." In fact, the AICPA's SEC Practice Section requires a change in the partner in charge of a public company audit at least every seven years. This membership requirement was adopted for the specific purpose of periodically bringing a fresh perspective to each audit without causing the detrimental effects of mandatory audit firm rotation.

THE EXPANDING ROLE OF AUDITORS

Propelled by changing client needs, growing public expectations and marketplace demands and opportunities, the public accounting profession in the United States has changed dramatically over the years.

Moreover, current developments—increasing global competition, more and more complex business structures and transactions, the continual creation of new and innovative financial instruments, and rapid technological breakthroughs, to cite only a few examples—will continue to affect the role and responsibilities of the accounting profession.

Concurrently, the investing public and government are asking auditors to assume greater responsibility. For example, the recent Federal Deposit Insurance Corporation Improvement Act of 1991 includes a new requirement for auditors' reports on the internal control structure and procedures for financial reporting and an institution's compliance with certain specified laws and regulations relating to safety and soundness. Furthermore, some believe financial statements should be changed to include forecasts or other future-oriented information, which would have a significant effect on the auditor's responsibility. The profession is currently taking steps to address these and other challenges and opportunities.

Given this dynamic business environment and a desire for greater and more continuous auditor involvement in the financial reporting process, the need for auditors to have a thorough understanding of a client's operations is becoming much more apparent. Robert K. Mautz, Vice Chairman of the Public Oversight Board and Professor Emeritus of the University of Illinois and the University of Michigan perhaps said it best in 1974, "the auditor well acquainted with the client has an advantage not compensated for by new-broom alertness."

AUDIT INDEPENDENCE AND OBJECTIVITY

Maintaining public confidence in the integrity and objectivity of auditors is essential to the smooth functioning of capital and debt markets. To maintain such confidence, the AICPA has long required CPAs to be independent in performing audit and other attest services. Furthermore, the Securities and Exchange Commission, other federal and state regulatory agencies, state legislatures, and state boards of accountancy often include independence requirements in their laws and regulations.

Key factors that help to assure the objectivity, independence and professional behavior of public accounting firms are summarized below:

- First, a firm's greatest asset is its reputation. No firm should knowingly or deliberately sacrifice this hard-earned reputation for short-term financial advantage or gain.
- Second, because auditing is a major source of revenue for most firms, a strong financial incentive exists to protect and enhance the audit practice.
- Third, every firm represented in the AICPA is required by AICPA standards to develop and maintain a system of quality control to protect audit quality and independence.
- Fourth, the profession's peer review program critically evaluates firm-maintained controls, as well as compliance with other professional standards.
- Fifth, the Securities and Exchange Commission investigates instances of suspected audit failure involving public companies and brings enforcement actions against firms and individuals deemed guilty of substandard performance.
- Sixth, the cost of litigation and the accompanying negative publicity are ever-present deterrents.
- Seventh, individual professionals recognize that unprofessional behavior will destroy their careers, their livelihoods and possibly even their accumulated estates as well.
- Eighth, audit committees can and do closely monitor the quality, performance and independence of outside auditors.

RECENT STEPS TO FURTHER PROMOTE THE QUALITY OF AUDITS

Despite the foregoing safeguards audit failures do occur. Because audits are subject to cost/benefit constraints and are the product of human endeavor, a perfect record—no audit failures whatsoever—is impossible to achieve. However, that has not diminished the profession's commitment to the objective.

Auditors have long understood that failures can destroy professional reputations and have carefully approached their professional responsibilities accordingly. However, the profession's extraordinary commitment to new approaches to quality control and professional practice review in recent years provides even further assurance to the public that audit firms will perform their expanding responsibilities objectively and competently.

In addition to the factors noted previously, the following further measures help to maintain the quality of audits:

- Every accounting firm with AICPA members must have a system of quality control and that system must be reviewed by other CPAs every three years. This peer review requirement was first established by the SEC and Private Companies Practice Sections—voluntary membership groups—of its Division for CPA Firms in 1977. Because of its success, AICPA members voted in January 1988 to require all firms with AICPA members to undergo a similar independent, triennial review and the Quality Review Program for firms that are not members of the Division for CPA Firms was established.
- Beginning in 1990, auditors whose clients include SEC registrants have been required to be members of the SEC Practice Section. As of December 31, 1991, 1,179 accounting firms (which together audit over 14,400 SEC registered companies, that account for approximately 99% of the revenue of all such companies) are members of the SEC Practice Section.
- The SEC Practice Section requires that its member firms rotate the engagement partner responsible for the audit of a public company after seven years. This ensures that a fresh perspective is brought to these engagements without sacrificing institutional knowledge of the client.
- Public company audits also must receive a second partner review prior to issuance of the audit report. That second review cannot be performed by a partner with significant involvement in the performance of the audit engagement itself.
- The SEC Practice Section—through its Quality Control Inquiry Committee—reviews and makes inquiries regarding the quality control implications of alleged audit failures involving public clients of member firms in order to identify and address in a timely fashion any quality control improvements that may be needed.
- The peer review and other requirements of the SEC Practice Section are scrutinized and reported on by both an independent Public Oversight Board and the SEC. The POB is an autonomous body consisting of five distinguished individuals with a broad spectrum of business, professional, regulatory and legislative experience. It carefully monitors all of the Section's self-regulation programs and, in its most recent annual report, concluded that such program "are suitably comprehensive and operating in a manner that reasonably assures that member firms have appropriate quality control systems and that they comply with them." Similarly, the SEC, which has fully endorsed the peer review program for many years, reported to Congress in 1991 that the quality control inquiry process provides added assurances that major quality control deficiencies, if any, are timely identified and addressed in the public interest.
- The SEC requires registrants to report publicly all accounting or auditing disagreements when an auditor resigns, is removed or replaced, and peer reviewers are required to focus on such situations in their triennial reviews. This inhibits companies from firing auditors with impunity.
- In addition, Statement on Auditing Standards No. 61, *Communication With Audit Committees*, requires the auditor to discuss with the audit committee any disagreements with management about significant issues, whether or not they are satisfactorily resolved. It became effective for audits of financial statements beginning January 1, 1989.
- Other recent Statements on Auditing Standards include more stringent auditor responsibilities with respect to

  — detection and reporting of errors and irregularities

  — illegal acts by clients

  — consideration of the internal control structure in a financial statement audit

  — communications of internal control weaknesses noted in an audit

  — consideration of an entity's ability to continue as a going concern and further improvements and refinements to generally accepted auditing standards are constantly under consideration by the Auditing Standards Board.

CONCLUSION

Mandatory audit firm rotation would not enhance audit quality or strengthen investor confidence in the objectivity of audits—already protected by numerous safeguards. To the contrary, rotation would be very costly and counterproductive to the advancement of the public interest. Moreover, it would at least be partly redundant since individual auditors responsible for the audits of public companies already must rotate.

Based on a number of studies and years of audit experience, the profession strongly believes that mandatory rotation would actually heighten the risk of audit failure by curtailing audit firms' ability to get and keep the in-depth institutional knowledge of a client entity and its business which is critical to early discovery and resolution of problems that may threaten a business. The public interest lies in early warning and the prompt correction of errors or abuses that threaten the entities in which people invest. We believe audit firm rotation would retard progress toward this important goal.

(Adopted by the SEC Practice Section
Executive Committee March 24, 1992)